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# THE B&B ALERT

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## ***QUALIFIED DISABILITY TRUST*** ***By Thomas D. Begley, Jr., Esquire***

### ***Introduction***

A Qualified Disability Trust is a form of Special Needs Trust that allows the trust to take advantage of a personal exemption for income tax purposes. The trust must meet the requirements set forth in the Internal Revenue Code<sup>1</sup> and the trust must be designed to meet the requirements of 42 U.S.C. §1396p(c)(2)(B)(iv).

A Qualified Disability Trust must be a non-grantor trust.<sup>2</sup> A Self-Settled Special Needs Trust is always a grantor trust. A Qualified Disability Trust must be a third party trust.

### ***Qualified Disability Trust Requirements***

To satisfy the requirements of the Code a Qualified Disability Trust must be an:<sup>3</sup>

- irrevocable trust

<sup>1</sup>FN-I.R.C. §242(b)(2)(C).

<sup>2</sup>Instructions for Form 1041 and Schedules A, B, D, G, I, J and K (2006).

<sup>3</sup>42 U.S.C. §1396p(c)(2)(B)(iv).

- established “solely for the benefit of”
- an individual under age 65
- who is disabled as defined in the Social Security Act 42 U.S.C. §1382c(a)(3).

The “sole benefit” requirement is met only if no other person or entity can benefit from the transferred resources at the time of the transfer or for the remainder of that person’s life.<sup>4</sup> The sole benefit of requirement cannot be met unless the trust is irrevocable.

The disability test is met if the beneficiary is disabled for some portion of the tax year for which the exemption is claimed.<sup>5</sup> However, there must be a determination of disability by SSA.<sup>6</sup>

### ***Personal Exemption***

A Qualified Disability Trust is allowed a deduction equal to the personal exemption.<sup>7</sup>

A Qualified Disability Trust is defined as any trust if:

- The trust is a disability trust described in 42 U.S.C. §1396p(c)(2)(B)(iv) discussed above<sup>8</sup> and all of the beneficiaries of the trust as the close of the taxable year are determined by SSA to have been disabled within the meaning of 42 U.S.C. §1382c(e)(3) for some portion of such year.<sup>9</sup>

The trust does not fail to meet the requirement that all beneficiaries must be disabled merely because the corpus of the trust may revert to a person who is not so disabled after the trust ceases to have any beneficiary who is disabled.<sup>10</sup>

### ***Effect of a Qualified Disability Trust***

Generally, a trustee must file an income tax return for a trust that has:

- any taxable income for the year;
- gross income of \$600 or more; or

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<sup>4</sup>POMS S.I. 01150.120.B.8.

<sup>5</sup>I.R.C. §642(b)(C).

<sup>6</sup>*Id.*

<sup>7</sup>I.R.C. §642(b)(2)(C)(i).

<sup>8</sup>I.R.C. §642(b)(2)(C)(ii)(I).

<sup>9</sup>I.R.C. §642(b)(2)(C)(ii)(II).

<sup>10</sup>*Id.*

- a beneficiary who is a non-resident alien.

A Qualified Disability Trust is granted a personal exemption by the I.R.S. Net income retained by the trust up to the amount of the personal exemption is not taxed. The trust pays income tax on any retained income in excess of the personal exemption amount. The personal exemption amount is determined as follows:

- If the trust is required to or actually distributes all of its income, the personal exemption is \$300.
- If the trust accumulates income, the personal exemption is \$100.
- The Qualified Disability Trust receive a personal exemption in the same amount as an individual. For 2007, that amount is \$3,400.<sup>11</sup>

The ability of the trust to use the personal exemption is significant because trust marginal income tax bracket rise steeply. For 2007, a trust pays tax at the marginal federal rate of 35% on net income over \$10,450.<sup>12</sup>

To the extent that income is distributed from the trust, it is taxable to the beneficiary at the beneficiary's lower income tax rate. A Qualified Disability Trust enables the trust to retain some income and have it offset by the trust personal exemption.

The ability to retain income in the special needs trust makes it an attractive tax advantaged savings vehicle. If the accumulated tax-free income is distributed in the later year, it will be a tax-free principal distribution.

Whether capital gains income is considered income for trust accounting purposes is left to the discretion of the trustee.<sup>13</sup> The only restriction is that the trustee must be consistent from year to year.<sup>14</sup>

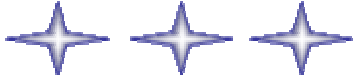
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<sup>11</sup>Rev. Proc. 2006-53 §3.18.

<sup>12</sup>Rev. Proc. 2006-53 §3.01 Table 5.

<sup>13</sup>Treas. Reg. 1.643(a)-3 (2004).

<sup>14</sup>*Id.*



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## Speakers

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## Begley & Bookbinder

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